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No. 89-1179

In the Supreme Court of the United States

OCTOBER TERM, 1989

JEROME MIRZA & ASSOCIATES, LTD., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the Commissioner was required to defer to petitioner's actuary and allow petitioner's claimed deduction for a pension contribution, even though the actuarial assumptions upon which that contribution deduction were based were unreasonable.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-10) is reported at 882 F.2d 229. The opinion of the district court (Pet. App. 11-24) is reported at 692 F. Supp. 918.

JURISDICTION

The judgment of the court of appeals was entered on August 10, 1989. A petition for rehearing was denied on October 25, 1989 (Pet. App. 26). The petition for a writ of certiorari was filed on January 23, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a professional corporation engaged in the business of rendering legal services. It is wholly owned

and controlled by Jerome Mirza, a practicing attorney. On December 31, 1980, petitioner adopted the "Jerome Mirza & Associates, Ltd., Defined Benefit Pension Plan," with an effective date of January 1, 1980. The plan provided that it was intended to be a "qualified plan" under the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829—*i.e.*, within the meaning of Section 401(a) of the Internal Revenue Code (26 U.S.C.)—and should be construed to comply with the Code's requirements for qualification. Under the plan, a participant was entitled to an accrued benefit in the amount of 30% of compensation for the first year of participation beginning on or after January 1, 1980, plus 5% of compensation for each of the next three years of participation, reduced by an amount reflecting Social Security benefits. The benefit was payable in annual installments beginning on the date the participant reached age 55 with 10 years of plan participation. This annual payment could not exceed $110,625. Pet. App. 12-13.

In 1980, the Mirza Plan covered two employees, Jerome Mirza and David Dorris. Mirza was 43 years old and had been employed by petitioner for seven years prior to 1980. Dorris was 33 years old and had been employed for five years. Mirza's compensation in 1980 was $275,000, and the plan actuary calculated that, under the plan's benefit formula, he was entitled to an annual benefit in the amount of $80,927 upon reaching retirement age. Dorris's compensation was $27,000, of which he elected to have $9,760 considered for pension purposes, resulting in an accrued benefit of $1,215, as calculated by the plan actuary. Pet. App. 13.

The actuarial calculations necessary to determine the cost of the benefits provided by the Mirza Plan were made by Joseph Beres, an enrolled actuary with a firm of consulting actuaries, and he certified that the actuarial assumptions and methods used were reasonable in the aggregate, as re-

quired by Section 412(c)(3) of the Code. Beres chose the unit credit cost method and used a 5% interest rate assumption in making his calculations. In order to compute the "normal cost" of a plan – *i.e.*, the cost allocable to the services performed by the plan participants in the computation year – an actuary using this method computes the cost of an annuity beginning at normal retirement age in the amount of the benefit attributable to each participant's current year of service, and then discounts that cost to present value using his stated interest assumption. Beres allocated to the normal cost of the plan for 1980 the entire cost of the pensions payable at the end of 1980 (*i.e.*, Mirza's annuity upon retirement of $80,927 per year and Dorris's annuity upon retirement of $1,215 per year). He then calculated a total present value, as of the end of December 31, 1980, of $625,925 for these accrued benefits. Beres concluded that this amount represented the normal cost of the plan, and he advised petitioner that this amount therefore was deductible for 1980 under Section 404(a)(1)(A) of the Code. This deduction generated a net operating loss for petitioner for 1980 in the amount of $546,887. Pet. App. 2-3, 13-14.

2. On audit, the Commissioner disallowed a large part of the claimed pension contribution deduction on petitioner's 1980 return. The disallowance was made in two stages. First, recognizing that the plan contributions were invested in certificates of deposit paying between 11.65% and 15.75%, the Commissioner determined that the interest assumption of 5% used by Beres was much too low, and he changed the assumed interest rate to 8%. This change in the discount rate used in the Mirza Plan had the effect of reducing the present cost of future benefits from $625,925 to $442,010.[1] Pet. App. 3-5, 15.

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[1] The actuary's interest rate assumption hypothesizes a rate of return earned on the plan's assets that will generate sufficient funds to pay

Second, the Commissioner determined that Beres had failed to apply the unit credit cost method correctly in allocating all of the costs of the benefits to 1980, instead of recognizing that some of the costs were attributable to the participants' past service for petitioner. In particular, Mirza's benefit of $80,927 per year could not be attributed in its entirety to his service in 1980, because treating a benefit of that size as earned in a single year would violate the limit on benefits payable under a qualified plan contained in Section 415(b)(5) of the Code. Accordingly, the Commissioner amortized the cost over ten years, allocating $63,759 of the total plan cost for 1980 to the normal cost of the plan, which was deductible in 1980, and allocating $378,251 of the total plan cost to past service cost. Of that latter amount, $52,195 was deductible immediately in 1980, in accordance with the formula set forth in Section 404(a)(1)(A)(iii) of the Code. The sum of the normal cost and the currently deductible portion of the past service cost resulted in an allowable deduction under Section 404 of $115,954. Pet. App. 14-15.

3. Petitioner paid the resulting deficiency and, after filing a timely claim for refund, brought this refund suit in the United States District Court for the Central District of Illinois. The district court sustained the Commissioner's position with respect to both the interest rate and the allocation issues (Pet. App. 11-24). On the interest rate issue, the court noted that Section 412(c)(3) of the Code requires an actuary to choose assumptions that are reasonable in the aggregate, taking into account the experience of the plan and the actuary's reasonable expectations of anticipated future experience under the plan. Given that the plan

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a retirement benefit of a given amount at a determinable date in the future. The lower the assumed rate of return, the higher must be the amount contributed in order to fund the pension liability. Thus, the assumption of a lower rate of return justifies a higher contribution, and a larger corresponding tax deduction.

trustees had invested almost all of the plan assets in certificates of deposit earning between 11.65% and 15.75%, the court concluded that it was unreasonable for the plan actuary to have selected an interest rate assumption of only 5% in determining the benefit liabilities of the plan (Pet. App. 20-21). Moreover, the court noted that the Mirza Plan was "front-loaded"—*i.e.*, designed so that the plan benefits would accrue over a short period of time at the beginning of the plan's existence—which tended to increase the proportion of the total cost of the plan that would be accrued and funded during the initial years of its existence, when the plan trustees could lock in the high interest rates prevailing in 1980 and 1981 (*id.* at 22-23).

With respect to the allocation issue, the district court held that Section 415(b)(5) of the Code required an allocation between normal cost and past service cost. The court explained that the qualification rules for defined benefit plans would not permit Mirza to accrue a benefit of more than $11,062 per year based on his service for 1980 alone, and therefore the annual benefit in the amount of $80,927 provided in the Mirza Plan was allowable only because Mirza had seven years of pre-1980 service that could be taken into account in computing the benefit limit. Since the plan expressly stated that it should be interpreted in order to be eligible as a qualified plan, the plan actuary was required to make an allocation between the normal cost and the past service cost of the plan in order to avoid violating the benefit limits of Section 415 of the Code. Applying the allocation prescribed in Section 404(a)(1)(A)(iii) of the Code, the district court concluded that the Commissioner had correctly limited petitioner's deduction for its contribution to the Mirza Plan in 1980 to $115,954. Pet. App. 19-20.

3. The court of appeals affirmed (Pet. App. 1-10). The court concluded that there was ample support for the district court's conclusion that, in light of the Mirza Plan's high-

yielding investments and heavily front-loaded design, the plan actuary had acted unreasonably in assuming a 5% interest rate, and therefore it declined to disturb the district court's conclusion (*id.* at 5-6). The court also sustained the district court's allocation, noting that allowing a plan to fund benefits in excess of the Section 415 limits on benefit payments – as the actuary proposed here – would nullify the statutory requirement that plans using the unit credit cost method must amortize their past service costs over a minimum of ten years (Pet. App. 7-10).

ARGUMENT

The court of appeals correctly affirmed the district court's judgment in this case, and its decision does not conflict with any decision of this Court or of another court of appeals. Moreover, the questions decided by the court of appeals present no issue of broad legal importance; rather, they involve factbound determinations concerning the specialized issue of the reasonableness of the actuarial assumptions and methods used in determining pension plan costs. Accordingly, there is no reason for review by this Court.

1. Section 412(c)(3) of the Code provides that costs and other factors under a pension plan "shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan." These actuarial assumptions not only affect the employer's obligation to make sufficient payments into its plan to satisfy the minimum funding standard under Section 412, they also affect the determination of the limit on deductible contributions under Section 404(a)(1)(A) of the Code. That Section provides explicitly that "[i]n determining the amount deduc-

tible * * * the funding method and the actuarial assumptions used shall be those used * * * under section 412." The courts below considered the factors that Congress determined should be taken into account and correctly concluded that the actuarial assumptions that formed the basis for petitioner's 1980 deduction were not "reasonable" within the meaning of Section 412.

Petitioner does not seriously dispute the courts' conclusion that the actuary's assumptions were not reasonable. Rather, petitioner's primary contention (Pet. 10-21) is that the actuary should be deemed to be a "fiduciary" of petitioner, and therefore the courts were obligated to pay "great deference" (Pet. 15) to the actuary's decisions and to follow his assumptions as long as his methods were "procedurally prudent" (Pet. 20). This contention is entirely without merit.

In referring to the actuarial methods and assumptions chosen by the plan actuary, Congress did not purport or intend to delegate control over the determination of the employer's tax liability to the untrammelled discretion of the employer and its actuary. As with other aspects of a taxpayer's reported tax liability, the general enforcement and administrative responsibilities conferred upon the Secretary of the Treasury (and his delegate, the Commissioner) (see 26 U.S.C. 7801, 7802) empower him to question the correctness of a deduction taken for pension plan contributions under Section 404(a)(1). To the extent that claimed deduction rests on actuarial assumptions, the Commissioner, in auditing the employer's taxes, has the power to question the reasonableness of those assumptions within the meaning of Section 412. Nothing in the statute indicates that Congress intended to divest the Secretary of this authority in favor of blind acceptance of the actuary's chosen assumptions. Indeed, the House Ways and Means Committee directly stated to the contrary in its report on the legislation, noting that "[t]he Secretary of the Treasury

is also to review the actuarial assumptions used by particular plans and an advisory board of actuaries is to be established to assist him in setting up general standards as to reasonableness of assumptions." H.R. Rep. No. 807, 93d Cong., 2d Sess. 27-28 (1974). See also S. Rep. No. 383, 93d Cong., 1st Sess. 69-70 (1973) (in order to prevent distortion of income, a plan sponsor must obtain approval from the Internal Revenue Service for any changes in the selection of an actuarial cost method before the new method is used to calculate plan costs).[2]

2. There is no merit to petitioner's assertion (Pet. 9, 19-20) that the decision below conflicts with *British Motor Car Distributors, Ltd.* v. *San Francisco Automotive Industries Welfare Fund*, 882 F.2d 371, 376 (9th Cir. 1989). The latter case involved an attempt by an employer to recover some of the surplus assets of a terminated multiemployer pension fund, invoking Section 403(c)(2)(A)(ii) of Title I of ERISA, 29 U.S.C. 1103(c)(2)(A)(ii). Section 403(c), however, provides that the assets of a plan generally cannot inure to the benefit of an employer except in certain

[2] Citing a report and other material generated by the House Committee on Education and Labor, petitioner argues (Pet. 13-14) that the plan actuary must be regarded as a "fiduciary." The material cited, however, comes from the legislative history of the labor provisions of ERISA, Title I, 29 U.S.C. 1001 *et seq.*, and is addressed to the question whether plan actuaries should be subject to the fiduciary responsibilities imposed by those provisions. That discussion has no bearing on the role of the actuary in the enforcement of Title II of ERISA, the tax provisions, which are contained in the Internal Revenue Code (26 U.S.C. 401 *et seq.*), and they certainly lend no support to the contention that the Commissioner must defer to the assumptions made by the fiduciary, even if they are objectively unreasonable. As we noted in the text, the report of the House Ways and Means Committee on the tax provisions of ERISA clearly indicates that Congress contemplated that the Commissioner would conduct an independent review of the reasonableness of those assumptions in the course of executing his responsibilities in enforcing the Internal Revenue Code.

situations, including a contribution made by "mistake of fact or law." The court of appeals in *British Motor Car* rejected the employer's contention that, because the surplus resulted from actuarial projections that turned out to be inaccurate, this exception was applicable. The court explained that these projections involve estimations and predictions about various contingencies, and therefore cannot be regarded as "mistake[s] of fact" when they do not correctly predict the experience of the plan; the court also noted that ERISA generally contemplates "deference to fiduciary decision-making" and there was no indication that Section 403 was designed "to allow courts to substitute their judgments for the judgments of fiduciaries on decisions involving actuarial rates." See 882 F.2d at 376.

Plainly, the decision in *British Motor Car* in that completely different context does not conflict with the decision here. The conclusion that an employer may not recover contributions to a plan by arguing that actuarial assumptions resulting in a surplus were "mistake[s] of fact" in no way suggests that the Commissioner may not challenge the reasonableness of actuarial assumptions that lead to large tax deductions.[3] Moreover, even if an employer's effort to challenge actuarial assumptions as "mistake[s] of fact" under 29 U.S.C. 1103 for purposes of recovering excess contributions could be equated with the Commissioner's consideration of the "reasonable[ness]" of actuarial assumptions under 26 U.S.C. 412 for purposes of auditing the employer's tax liability, this case is still quite different from *British Motor Car*. The employer in that case did not attempt to show that the actuarial assumptions were unreasonable when

[3] Indeed, the House Report specifically noted that it is "inappropriate" for the employer to second-guess the actuary's assumptions, but that "it is anticipated that, on audit, the Internal Revenue Service will * * * require a change of assumptions where they do not meet this [reasonableness] standard." H.R. Rep. No. 807, *supra*, at 95.

made; rather, it simply relied upon the difference between the projected benefit liabilities and those actually experienced. Here, by contrast, the district court found, on the basis of abundant evidence, that the actuary's 5% interest rate assumption was unreasonable when made. Even under a standard of review that accords deference to the actuary, the Commissioner was not required to accept this assumption as "reasonable" in calculating petitioner's tax liability.

3. Although not encompassed in the question presented, petitioner briefly raises two other objections to the decision below. Citing a statement in one of the House Reports, H.R. Rep. No. 779, 93d Cong., 2d Sess. 94 (1974), petitioner argues (Pet. 21) that, since the district court did not state that the assumptions chosen by the actuary were "substantially" unreasonable, the Commissioner's adjustments to those assumptions should have been limited to years after the date of the audit and could not be made retroactive to 1980, the year at issue here. This argument is untenable. Petitioner claimed a tax deduction in the amount of $625,925 for its contribution to a plan covering only two employees, most of whose benefits were intended for Jerome Mirza, petitioner's sole shareholder. The Commissioner determined that this claim was grossly inflated, and asserted that under a reasonable interest rate assumption and a correct application of the unit credit cost method, the amount allowable was only $115,954, or less than 20% of the amount claimed by petitioner. The district court and the court of appeals both sustained the Commissioner's determination in full. Moreover, the actuary's interest rate assumption was 5%, when most of the money was invested at, and could be locked into, interest rates of 11.65% and higher. These circumstances plainly satisfy any requirement that the actuarial assumptions be "substantially unreasonable."

Petitioner also briefly appears to argue (Pet. 21-23) that the court of appeals erred in holding, as a matter of law, that the benefit accrued by Jerome Mirza in 1980 must be allocated between the portion attributable to normal cost and the portion attributable to past service cost. As petitioner acknowledged in its brief in the court of appeals (at 27-28), this issue is of no continuing importance because petitioner's position is completely untenable in light of a statutory amendment made to 26 U.S.C. 415 by the Tax Reform Act of 1986. See Pub. L. No. 99-514, § 1106, 100 Stat. 2424-2425. In any event, petitioner's contention was correctly rejected by the court of appeals (see Pet. App. 9); there is no authority whatsoever for the proposition that a plan sponsor may accrue and deduct contributions that are used to fund benefits in excess of the limit imposed by Section 415(b)(5) of the Code on the benefits payable under the plan. Indeed, in *Feichtinger* v. *Commissioner*, 80 T.C. 239 (1983), the Tax Court sustained the Commissioner's determination that a plan would fail to qualify under Section 401 of the Code if its governing instrument permitted the plan actuary to estimate and provide for advance funding of future cost of living increases in the Section 415 benefit limits. The court noted that the limits provided in Section 415 were intended to prevent taxpayers from using tax-sheltered pension plans to fund unreasonably large pension benefits, and that it would defeat this purpose to allow a sponsor of a qualified plan to obtain a current deduction for funding benefits in excess of those allowable at the time the contribution was made. 80 T.C. at 249-250.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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